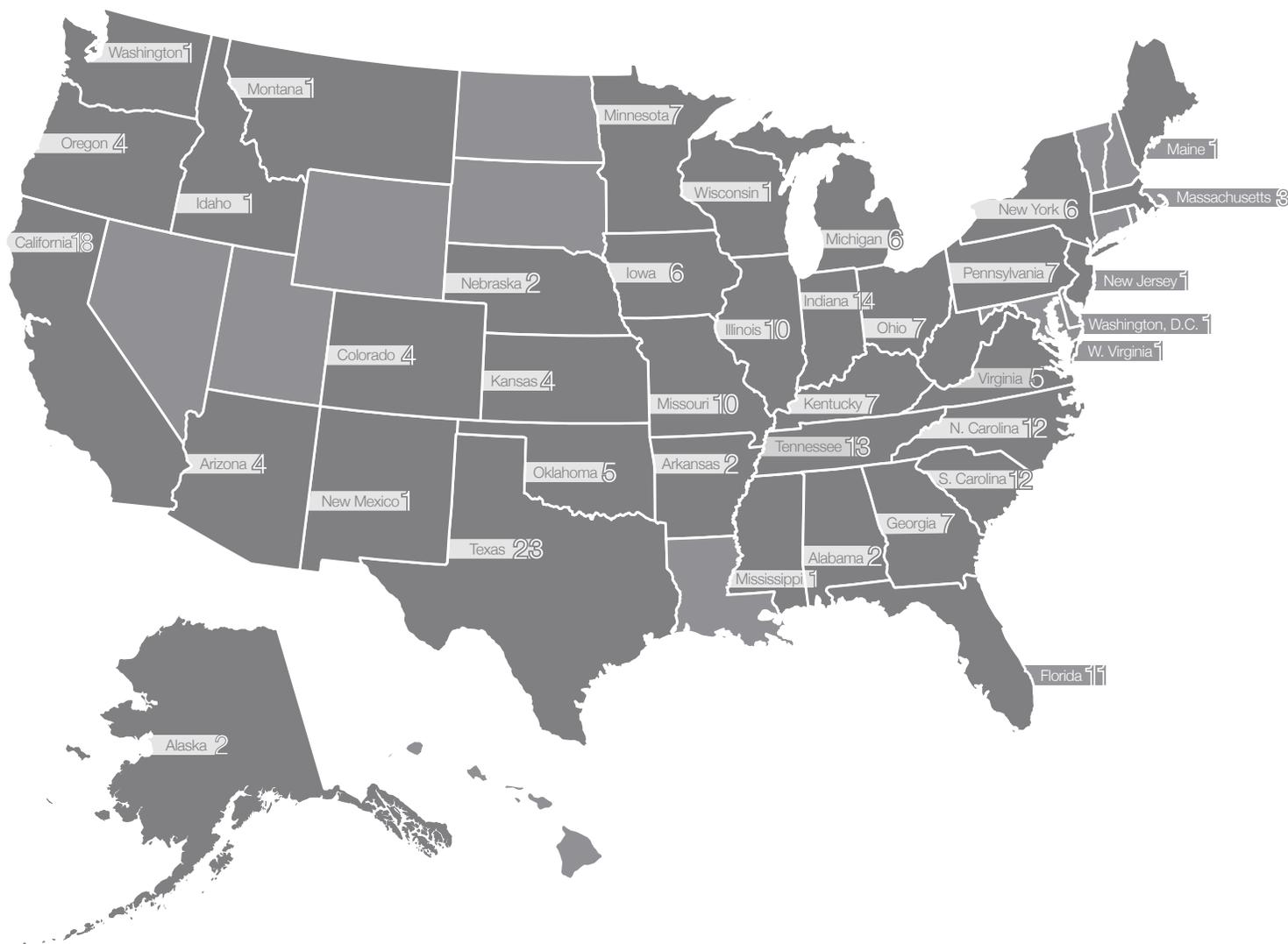


2013 Higher Education Tax Reporting Trends Project

SUMMER 2013



Christ's Chapel, Oral Roberts University, Tulsa, OK



We are very pleased to present the 2013 edition of CapinCrouse LLP's annual *Higher Education Tax Reporting Trends Project*. We would like to start by sincerely thanking the 223 colleges and universities that participated in the study. Participating institutions were located in 38 states across the U.S., from Maine to Alaska and California to Florida.

Of the respondents, 156 have intercollegiate sports programs while 67 do not. Among those that do, 66 schools participate in the NCAA and are responsible for reporting to that organization.

The current enrollment of the 223 participating institutions of higher education averaged 1,712, with the largest having 17,589 students and the smallest having an enrollment of 10 — quite a range.

We separated the respondents into three categories, based on enrollment size:

	Category A	Category B	Category C
Enrollment	1,700+	500 -1,700	Under 500
Respondents	71	76	76

August 2013

Dear Colleague,

Welcome to the fourth edition of CapinCrouse's annual *Higher Education Tax Reporting Trends Project*. This unique statistical review includes financial, tax, and demographic data compiled from our 2013 college, university, and seminary web survey and from the 2011 Return of Organization Exempt from Income Tax (Form 990) filed by 183 of the respondents. We have moved the publication of this report to summer from our traditional fall release.

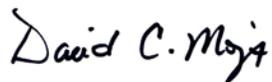
Our goal is for this report to be a useful reference guide and information tool when preparing and reviewing your 2012 Form 990 (for the year ending in 2013). While we recognize that no two higher education institutions are exactly alike, the editorial and statistical information contained here should help your accounting team gain a better understanding of tax reporting and the manner in which peer institutions answer line items on the annual Form 990.

Our annual survey — which participants completed online, at conferences, and via email — was a great success again this year. We incorporated a chapel theme that seemed to interest many people. As you will see throughout this report, respondents submitted beautiful pictures of chapel venues on their campuses, and we are sorry that we could not use them all.

Again, it is our hope that you are able to use the data in this report to help with your future tax compliance filings and assist in training and informing your board, management group, and accounting team. We would be happy to discuss any questions you may have or how any of these industry-wide tax reporting trends may be affecting your institution.

Also, we welcome any comments and suggestions on how we might improve the content or presentation of this report in future years. Please direct your comments or questions to collegetax@capincrouse.com. We appreciate your continued support and thank you for allowing us to serve your audit, tax, and consulting needs.

Sincerely,



Dave Moja, Partner
National Director of Not-for-Profit Tax Services



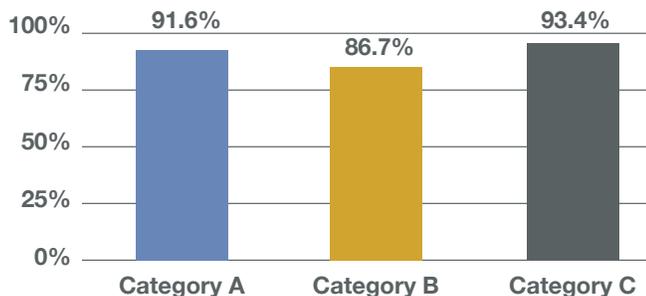
Ozinga Chapel, Trinity Christian College, Palos Heights, IL

SURVEY	Responses	"Yes" Responses			
		Total Survey	Category A Universities	Category B Universities	Category C Universities
Do you conduct chapel services at least weekly on campus?	222	90.5%	91.6%	86.7%	93.4%
Have you updated your conflict of interest policy in the past four years?	221	73.3%	77.1%	76.0%	67.1%
Do you contract with an outside vendor to provide food services for your students?	223	68.6%	85.9%	86.8%	34.2%
Does your institution receive non-cash gifts in most tax years?	222	86.9%	95.8%	84.0%	81.6%
Do you have a campus print shop?	223	35.0%	57.8%	34.2%	14.5%
Does your college have summer youth camps on campus?	223	69.1%	93.0%	79.0%	36.8%
Has your institution had a change at the president level in the past three years?	223	30.5%	23.9%	34.2%	32.9%
If you have a sports program, what association does your college belong to:					
NCAA	223	29.6%	60.6%	27.6%	2.6%
NCCAA	223	16.6%	9.9%	13.2%	26.3%
NAIA	223	20.6%	19.7%	39.5%	2.6%
Other	223	3.1%	1.4%	4.0%	4.0%
No Sports	223	30.0%	8.5%	15.8%	64.5%
FORM 990					
Does your school file a Form 990?	183	82.1%	91.6%	85.5%	69.7%
Does your school file a Form 990-T to report unrelated business income?	183	39.3%	64.6%	38.5%	9.4%
Does your institution hold endowment funds?	183	85.8%	92.3%	95.4%	66.0%
Do you report "family member" employees? (Part IV, Line 28b)	183	29.0%	46.2%	27.7%	9.4%
Is "comparative data" used to determine your president's compensation? (Part V, Line 15a)	183	88.0%	96.9%	87.7%	77.4%
Did you answer "Yes" to Schedule E, Line 7 — certification of non-discrimination policy?	183	99.5%	100.0%	100.0%	98.1%
Did you report gifts of "Taxidermy" on Schedule M, Line 21?	183	0.6%	1.5%	0.0%	0.0%

EXECUTIVE SUMMARY

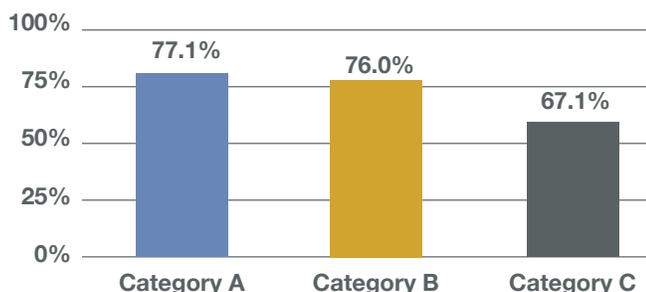
2013 Higher Education Tax Reporting Trends Project Survey

Do you conduct chapel services at least weekly on campus?



We felt this question would help define who participates in the *Higher Education Tax Reporting Trends Project*. We were pleased to find that almost 91% of this year's participants hold chapel. Following on that, we chose a chapel theme for this year's publication, and boy are we glad we did! As you'll see, the photos we received from survey participants are truly stunning. Several of the photos we received were of services in chapels, as represented by the one on Page 2.

Have you updated your conflict of interest policy in the past four years?

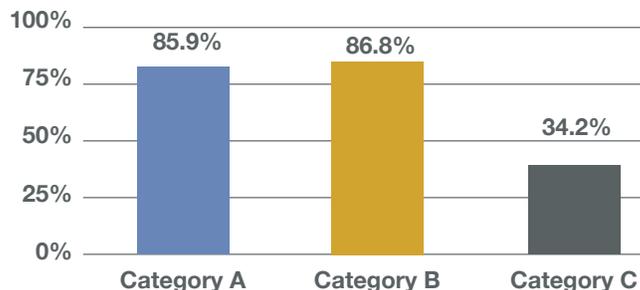


The IRS has become increasingly concerned with governance. Part VI of Form 990 is dedicated to "Governance, Management, and Disclosure." Form 990, Part VI, Line 12a asks, "Did the organization have a written Conflict of Interest Policy?" Line 12b of that part goes on to ask, "Were officers, directors, or trustees and key employees required to disclose annually interests that could give rise to conflicts?" Then, Line 12c asks, "Did the organization regularly and consistently monitor and enforce compliance with the policy?" For institutions that answer "Yes" to Line 12c, there is a requirement to "describe in Schedule O how this is done." Overall, just over 73% of our respondents stated that they have recently updated their conflict of interest policy. In our view, this number should be closer to 100%!

Our real reason for asking this question, though, was to determine whether the institutions had made changes in their conflict of interest policy to ensure compliance with Form 990, Part IV, Lines 25a through 28c. These Schedule L indicators include inquiries into whether the institution had "excess benefit transactions," loans to or from "interested parties," scholarships and/or grants paid to Form 990, Part VII individuals (plus major donors) and their families, or Schedule L, Part IV "business transactions." **We continually find that colleges and universities do not completely and accurately**

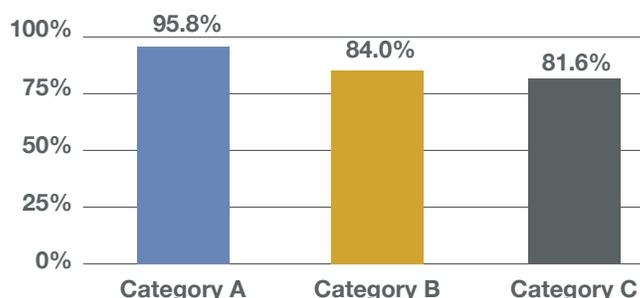
provide this "interested persons" information on their Form 990s because they do not ask the right questions. You should review the complicated instructions to Schedule L closely to ensure that your college, university, or seminary is properly complying with the "interested persons" reporting requirements.

Do you contract with an outside vendor to provide food services for your students?



Throughout 2013, we have been asked what our motivation was for including this question in the survey. In hindsight, to provide more clarity we could have asked two questions: "Do you provide food services on campus?" and "Do you contract with an outside vendor for those services?" With only 34% of Category C schools answering "Yes," we have to believe that many do not provide food services. (Category A and B reported 86% and 87%, respectively.) The impetus for this question was to discover whether there may be unrelated business income surrounding the institutions' food service activities. You should look closely at catering enterprises, whether the contract results in any "agency" relationships, and — for those schools with dining facilities covered by tax-exempt bonds — potential "private business use" issues. For schools that provide their own, in-house food services, catering and meetings can become even more of a potential unrelated business income tax (UBIT) issue.

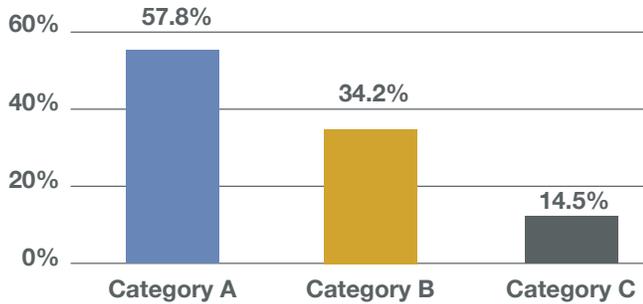
Does your institution receive non-cash gifts in most tax years?



Institutions that receive non-cash (sometimes referred to as "in-kind") contributions of more than \$25,000 during the tax year are required to file Schedule M (Form 990). You should be aware that this form can be a minefield of corroborating data that might end with an unsuspecting organization receiving an "inaccurate or incomplete" tag by the IRS on its annual return. For instance, if you answer "Yes" to Form 990, Part V, Line 7h (regarding the proper receipting of vehicle donations), you should have corresponding data on Schedule M, Line 6 and/or 7. (Incidentally, the Form 990 instructions state that if you do not have vehicle donations in a given tax year, Form 990, Part V, Line 7h should be left blank.)

Nearly 87% of the schools that participated in our survey said they regularly receive non-cash gifts. While this would appear to be a great indicator of a healthy development effort, you should know that charitable contribution deductions are under attack in Washington — especially non-cash contributions. From our standpoint, Congress and certain academics and critics rather vehemently and erroneously consider non-cash contributions to be an arena filled with tax-abusive schemes. Outside of a few isolated instances, this does not appear to be true in the real world. (Although we do believe that contributions for “taxidermy” should be done away with!)

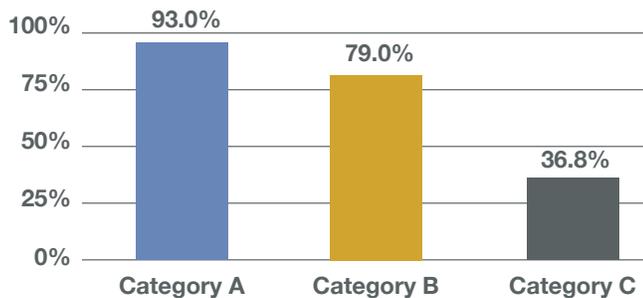
Do you have a campus print shop?



Many institutions of higher education have in-house printing facilities to support the academic purposes of their campus. Increasingly, we meet with colleges, universities, and seminaries that are providing print services to the general public to increase revenues. At several schools, innovative and sales-oriented “print shop” teams are courting this type of community business.

All schools should be aware that the IRS can separate the printing activities that are related to the institutions’ exempt purpose from those that it defines as unrelated, and it has a history of doing so. The unrelated printing activities are subject to UBIT, which is reported on Form 990-T. This should be tracked carefully to ascertain whether those activities show a profit each tax year. In our survey, 35% of all respondents reported having an on-campus print shop. Note that offering these services to the general public can be advantageous and provide much-needed cash flow for your school, but you should be aware of the potential tax pitfalls and additional reporting requirements that lurk if you venture into this arena.

Does your college have summer youth camps on campus?



Overall, 69% of the participating institutions answered “Yes” to this question. Only about a third of the smaller schools (Category C) reported that they hold these camps, however, while 93% of Category A schools hold them. Whether the camps focus on

basketball, football, cheerleading, music, spiritual growth, or Bible quizzes, this is a prevalent part of campus life in the hot months.

The Final Report of the IRS’s Colleges and Universities Compliance Project (CUCP), which is covered later in this publication, specifically noted in its “Underreporting of Unrelated Business Taxable Income” summary section that 90% of the universities audited by the IRS as part of the Project had Form 990-T adjustments. “Sports camps” were listed as one of the top activities where “the majority of these adjustments came from.” You should be aware of the tax rules surrounding summer youth camps, especially with respect to services that may be provided to campers and fees or leases to coaches who run their own camps on your campus.

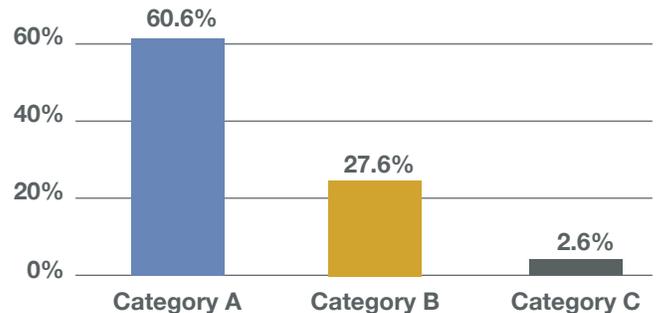
Has your institution had a change at the president level in the past three years?



There is still a great deal of publicity about the continuing “changing of the guard” in the top management official role at U.S. institutions of private higher education. (See the section on “Higher Education Leadership Transition” starting on page 11 of the CapinCrouse 2012 *Higher Education Update: Trends and Accounting Changes*. You can download a copy at www.capincrouse.com/what_we_offer/highered/news_and_events. Our goal in asking this question was to provide these interesting statistics, but also ensure that everyone is considering items such as presidential housing and the requirements under Internal Revenue Code Section 119 regarding non-taxable housing; deferred compensation plan regulations and reporting requirements; and reporting on Schedule J of Form 990.

If you have a sports program, what association does your college belong to:

NCAA



Sports and all that they entail represent a huge part of campus life for participating colleges and universities. It is quickly apparent that many of our Category C institutions do not have a sports program. Close to 90% of our Category A and B schools are

involved in intercollegiate sports, however. In addition, nine of the schools in this year's survey are currently converting to National Collegiate Athletic Association (NCAA) Division II for their athletic programs. There are compelling costs — both monetary and administrative — involved in making this switch.

This question raises several areas of interest for colleges and universities. First, sports activities can bring opportunities for UBIT, including banners in the gym, ads in programs, field rentals, and summer camps. Next, 61% of Category A and 28% of Category B institutions participate in the NCAA. These schools are required to complete NCAA "agreed upon procedures" reports periodically and there has been some cross-communication from the NCAA on these requirements for Division II in recent years.

Finally, this survey question opened the door for some great stories and questions regarding how accounting teams handle various sports issues. In recent months the CapinCrouse Tax Team has been holding joint meetings with the accounting and athletic departments at various schools. During these meetings we conduct a presentation designed to find common ground on understanding athletic and sports programs and reporting requirements. We would love to order pizza, bring our PowerPoint, and meet with the accounting and athletic folks at your school!

FORM 990: REVIEW OF DATA

This is our annual summary-within-a-summary compiled from our review of 183 Form 990s filed by the *2013 Tax Reporting Trends* survey respondents. The percentages under the first item are the number of 990 filers in each category over the total number of respondents in that category. For the other items, the percentages are based on the number of Form 990 filers in the given category.

Does your school file a Form 990?

- Category A: 65 filers (91.6%)
- Category B: 65 filers (85.5%)
- Category C: 53 filers (69.7%)

This is our standard question for this section. We gather this data by looking at the annual Return of Organization Exempt from Income Tax (Form 990) for those survey participants that file one. In 2012, 174 (83.3%) of participants filed Form 990. In 2013, 183 (82.1%) filed.

If your institution did not file a Form 990 this year, you should take great care to ensure that you do not meet the IRS's requirements for filing one. If the IRS determines that you are required to file Form 990 and you have not for three consecutive years, your exempt status will automatically be revoked.

Does your school file a Form 990-T to report unrelated business income?

- Category A: 64.6%
- Category B: 38.5%
- Category C: 9.4%

The CUCP Interim Report noted that 48% of the schools in its study with fewer than 5,000 students had never filed Form 990-T. This seemed to appall the IRS and many exempt organization observers. Four years later, 39.3% of all respondents in the *2013 Tax Reporting Trends* survey filed Form 990-T.

Form 990, Part V, Line 3a asks, "Did the organization have unrelated business gross income of \$1,000 or more during the year?" If "Yes," on Line 3b the organization is asked if it has filed a Form 990-T for the year. If the answer to that question is "No," an explanation must be provided on Schedule O. In the past, many institutions have been confused about the IRS's definition of "unrelated business gross income." The CUCP Final Report clarifies that an activity with "no profit motive" is not considered a trade or business and thus is not considered unrelated business income (UBI) — at least ostensibly. (See "Colleges and Universities Compliance Project Final Report Released" later in this publication.)

Did the organization, directly or through a related organization, hold assets in temporarily restricted endowments, permanent endowments, or quasi-endowments?

- Category A: 92.3%
- Category B: 95.4%
- Category C: 66.0%

This question is posed on Form 990, Part IV, Line 10. As you can see, many Form 990 filers in our survey answer this question "Yes." We are concerned, though, that there may be some misunderstanding about the definitions the IRS uses.

The Form 990 glossary defines these terms as follows:

Temporarily restricted endowment – Includes endowment funds established by donor-restricted gifts that are maintained to provide a source of income for either a specified period of time or until a specific event occurs (see SFAS 117 (ASC 958-205-45)), as well as all other temporarily restricted net assets held in a donor-restricted endowment, including unappropriated income from permanent endowments that is not subject to a permanent restriction.

Permanent (true) endowment – An endowment fund established by donor-restricted gifts that is maintained to provide a permanent source of income, with the stipulation that principal must be invested and kept intact in perpetuity, while only the income generated can be used by the organization. See SFAS 117 (ASC 958-205-45).

Quasi-endowment – An endowment fund established by the organization itself, either from unrestricted donor or organizational funds, over which the organization itself imposes restrictions on their use, and which restrictions can be temporary or permanent in nature. These funds are sometimes referred to as board-designated endowments. See SFAS 117 (ASC 958-205-45).

Also, for institutions that answer "Yes" on Form 990, Part IV, Line 10 and thus are required to complete Schedule D, Part V: please make sure the percentages entered at Schedule D, Part V, Line 2 add up to 100%!

The endowment question held a great deal of weight when the CUCP questionnaire was sent out in late 2008. By the time the Interim Report was released in May 2010, market adjustments and other factors had taken some of the spotlight off this issue. In fact, the Interim Report hedges its bets by stating, “Given the fluctuations in the financial markets since 2006, the responses to certain endowment related questions (e.g., valuation and spending practices) may be significantly different than if based on a more recent year.”

Currently, there is more discussion about potentially required “payouts” for college and university endowments. Private foundations generally must pay out 5% of assets, and the recent “permanent, temporary, and proposed” regulations for supporting organizations mandate a 3.5% annual payout.

Was the organization a party to a business transaction with one of the following parties: A family member of a current or former officer, director, trustee, or key employee?

- Category A: 46.2%
- Category B: 27.7%
- Category C: 9.4%

This comes from Form 990, Part IV, Line 28b. We find that many higher education institutions answer this question without considering it closely enough. Simply, if a “family member” (see below) makes more than \$10,000 in compensation from the filing institution, you must answer “Yes.” The Schedule L, Part IV instructions — which contain some of the most difficult-to-understand phraseology in the entire Form 990 — state:

In general, an organization must report business transactions in Part IV with an interested person if... compensation payments during the tax year by the organization to a family member of a current or former officer, director, trustee, or key employee of the organization listed in Form 990, Part VII, Section A exceeded \$10,000.

The Form 990 Glossary provides these definitions:

Family member, family relationship – Unless specified otherwise, the family of an individual includes only his or her spouse, ancestors, brothers and sisters (whether whole or half blood), children (whether natural or adopted), grandchildren, great-grandchildren, and spouses of brothers, sisters, children, grandchildren, and great-grandchildren.

Compensation – Unless otherwise provided, all forms of cash and noncash payments or benefits provided in exchange for services, including salary and wages, bonuses, severance payments, deferred payments, retirement benefits, fringe benefits, and other financial arrangements or transactions such as personal vehicles, meals, housing, personal and family educational benefits, below-market loans, payment of personal or family travel, entertainment, and personal use of the organization’s property. Compensation includes payments and other benefits provided to both employees and independent contractors in exchange for services. See also deferred compensation, nonqualified deferred compensation, and reportable compensation.

Note that the reporting here is for “compensation” in the tax year (not the W-2 reporting as in Form 990, Part VII, Section A).

Did the process for determining compensation of the following persons include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision:

The organization’s CEO, Executive Director, or top management official.

- Category A: 96.9%
- Category B: 87.7%
- Category C: 77.4%

This question comes from Form 990, Part VI, Line 15a. For institutions that answer “Yes” here, there is a requirement to describe the process on Schedule O. Due to the critical reporting in the CUCP Final Report with regard to potential “excess benefit transactions” and “comparability data,” we thought it would be compelling to look at this line of reporting.

Note that the next line item (Form 990, Part VI, Line 15b) asks about other officers or key employees of the organization. We chose to look at just Line 15a, but noted that over 30% of the institutions that answered “Yes” to Line 15a answered “No” to Line 15b (“Other officers or key employees of the organization”). Those institutions should review the “Compensation” section of the CUCP Final Report and reconsider their process for this issue.

This gist of this question comes from Treasury regulation section 53.4958-6, which is referred to as the “rebuttable presumption” process. The Executive Summary of the CUCP Final Report says:

An organization may shift the burden of proving unreasonable compensation to the IRS by following the three steps of the rebuttable presumption process:

- Using an independent body to review and determine the amount of compensation;
- Relying on appropriate comparability data to set the compensation amount; and
- Contemporaneously documenting the compensation-setting process.

If your school is like the 12% of institutions in our survey not following the “rebuttable presumption,” we strongly suggest that you adopt this procedure. See the “CUCP: Compensation” section of this publication for more information.

Does the organization certify that it has complied with the applicable requirements of sections 4.01 through 4.05 of Rev. Proc. 75-50, 1975-2 C.B. 587, covering racial nondiscrimination?

- Category A: 100%
- Category B: 100%
- Category C: 98.1%

This query comes from Schedule E, Line 7 and requires any organization answering “No” to provide an explanation on Schedule E, Part II. The reason for looking at this question is twofold. First, we wanted to ensure that this crucial annual certification question is answered properly. As you can see, we got the high percentages we were expecting! (The only non-“Yes” answer was actually left blank.)

But second, we wanted to open a discussion on this Revenue Procedure 75-50 “certification” for institutions that do not file Form 990 each year. Every tax-exempt school must annually certify to the IRS that it does not discriminate on the basis of race. The Supreme Court ruled in 1983 that a racially discriminatory school could not be tax exempt and that religion was not a defense.

Schools certify non-discrimination on Schedule E if they file Form 990 or on Form 5578 if they do not file Form 990 (because they are associated with a church). There’s the issue — are institutions that are not filing Form 990 actually filing Form 5578?

There is no formal correction process or penalty for schools that discover they are not in compliance or lack necessary records. The school should immediately begin complying and keeping records. A history of compliance after discovery of the requirements will carry substantial weight if any issues are raised in an IRS audit about racial nondiscrimination.

Did you report gifts of “Taxidermy” on Schedule M, Line 21?

- Category A: 1.5%
- Category B: 0.0%
- Category C: 0.0%

Many of you know that we have fun with this line item. We facetiously wanted to include a query into how much (or even if) this line is ever used by survey respondents. Well, we found one! Only one. And as we’ve said before, any bona fide “taxidermy” gifts could easily be reported on the “Other” lines on Schedule M.

There have been tax-based “taxidermy abuses” in the past. Press reports suggested that individuals involved in big game hunting were receiving deductions for contributing their mounted trophies at inflated prices, with the trophies often resold at a lower price. In addition to the revenue effects, environmental and animal rights groups expressed concern. The Pension Protection Act of 2006 explicitly restricted the deduction to the cost of mounting the trophy; thus, cost does not include the cost of hunting trips.

Dave Moja has campaigned to get rid of this line item to give us room in the format of the form to get a total line for Schedule M, Column C. He’s gotten so far as to get an email from an IRS Form 990 guru stating, “Thanks for the helpful suggestion, Dave — we’ll consider it.” Alas, the draft 2013 Schedule M does not have this line!

COLLEGES AND UNIVERSITIES COMPLIANCE PROJECT FINAL REPORT RELEASED

The IRS released its long-awaited Colleges and Universities Compliance Project (CUCP) Final Report on April 25, 2013, and then issued a slightly revised report (with changes highlighted in yellow) on May 2, 2013. The report is 105 pages long, with 37 pages of commentary plus a 68-page Appendix C with additional data. This supplements the 79-page Interim Report released in May 2010.

The Final Report was viewed as something of a disappointment in the higher education arena. The overall project seemed to be planned and carried out with diligence, however. The detailed questionnaire, which was sent to 400 randomly chosen colleges and universities at the start of the project in 2008, is well worded. The



Dogwoods seen from Dinwiddie Chapel, William Peace University, Raleigh, NC

Interim Report has very valuable data broken down by category, based on the number of full-time equivalent (FTE) students at an institution: small (less than 5,000 FTE), medium (between 5,000 and 15,000 FTE), and large (over 15,000 FTE). And as you will see below, the Final Report contains hints on how the IRS approaches colleges and universities, along with some useful data.

We recommend that everyone in higher education management and leadership review the Final Report, which is available at http://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf. It summarizes and editorializes upon data on unrelated business activities, compensation, employee benefit plans, and other matters from the 2008 questionnaire. Overall, we were left wanting specific information on various examination adjustments that are referred to without details, examples, or fanfare. We have found that reading the Final Report with a copy of the Interim Report close at hand can be very enlightening.

Ultimately, the Final Report was panned as a dud by most observers. Several noted that the Final Report focused so much on the 34 audited institutions that it myopically failed to provide valid data for use across the higher education arena. In an article titled “IRS Releases Final Report on College and University Compliance Project,” the National Association of College and University Business Officers (NACUBO) noted:

The report states that institutions largely attempted to comply with the intermediate sanction rule safe harbors, but about 20 percent of the private institutions examined* failed to do so because either they did not select truly similarly-situated institutions for purposes of compensation comparison, did not identify the selection criteria for the comparable institutions, or the surveys conducted did not specify whether amounts reported included just salary or other types of compensation as well.

*According to the report, about half of the 34 institutions selected for audit were private colleges or universities; therefore 20 percent of private schools audited would be approximately three or four institutions.

We had hoped the report would include more descriptive information on the nuts and bolts of the various adjustments. Over the months there was some discussion about specific examples, but that was not included. Appendix C does provide clarity with some “one-liners” from the narrative sections of the questionnaire responses and the audit findings.

From conversations with IRS officials involved in the project, we were led to believe that the Final Report might contain specific examples — modeled upon Revenue Ruling 2007-41, with example scenarios regarding political activities — that explained the IRS’s positions on various issues. As an example, we were expecting 20 to 25 scenarios in the vein of:

University A hires off-duty sheriff’s deputies to provide security on football-game Saturdays. The University provides a work schedule and location for the deputies but does not provide any equipment, etc. The University has historically treated these workers as independent contractors. The IRS reviewed the circumstances and determined that these workers should be considered employees based upon the criteria in Internal Revenue Code sections...

That said, however, we’d like to focus on some of the positive aspects of the Final Report (and the Interim Report) and look at three specific sections from the Final Report — “Unrelated Business Income,” “Compensation,” and “Additional Data Analysis” (where there are some interesting, significant trends) — to see what might be gleaned for institutions represented in this year’s *Higher Education Tax Reporting Trends Project*.

There is much to be learned when the Final Report data is combined with the May 2010 Interim Report data. Hopefully, we will get more clarification (perhaps even with specific examples) from the IRS in the upcoming months. For now, they appear to have other things on their minds...

Finally, as to next steps, the report states:

The examinations of college and universities identified some significant issues with respect to both UBI and compensation that may well be present elsewhere across the tax-exempt sector. As a result, the IRS plans to look at UBI reporting more broadly, especially at recurring losses and the allocation of expenses, and to ensure, through education and examinations, that tax-exempt organizations are aware of the importance of using appropriate comparability data when setting compensation.

CUCP: UNRELATED BUSINESS INCOME

The CUCP Final Report has much to say on the subject of unrelated business activities. The report begins its unrelated business income tax (UBIT) summary by stating:

A college or university is subject to tax on income from an unrelated trade or business. A trade or business is unrelated if it is not substantially related to the accomplishment of an organization’s exempt purposes, even if funds from the business are used to support those purposes.

We should all pay close attention to the nuances of what the IRS reported in this section of the Final Report. Building upon what is stated here, we predict several potential shifts in the way the

IRS begins to handle UBIT issues.

As mentioned previously, the Final Report recorded the following statistical data from the 34 examinations conducted as part of the project:

- 90% of audited colleges and universities ended up with increases to UBIT
- This included more than 180 adjustments totaling about \$90 million
- The IRS disallowed losses on 75% of returns examined
- The IRS disallowed more than \$170 million in losses and Net Operating Losses (which could amount to more than \$60 million in assessed taxes)

The report also noted that the following activities, which are listed in order of frequency, were connected to more than half of the adjustments made:

- Fitness and recreation centers and sports camps
- Advertising
- Facility rentals
- Arenas
- Golf courses

We’ve had conversations with several universities that believe because they do not engage in any of these activities, they don’t need to worry. It is very important, however, to rethink what the IRS is talking about with regard to some of these items — especially recreation centers, camps, and facility rentals. It would seem that many of the *2013 Tax Reporting Trends* survey respondents have some form of these activities.

One of the findings the IRS reported as a reason for unrelated business income adjustments was “lack of profit motive.” This is a double-edged sword in many ways. For several years, we have worked with colleges and universities to document consistent losses related to some of their unrelated business activities. We have taken the position that a “lack of profit motive” means the activity is generally not considered a trade or business — and thus not subject to UBIT. This finding appears to validate that thought process. The other edge of the sword, however, is that many institutions have offset profitable activities and built up net operating losses (NOLs) on Form 990-T by including activities with consistent losses. This is the issue the IRS adjusted on many Form 990-Ts in the CUCP.

The Final Report states:

A taxpayer can only generate UBI from a “trade or business.” An activity qualifies as a “trade or business” if, among other things, the taxpayer engaged in the activity with the intention of making a profit. A pattern of repeated losses is generally sufficient to show a lack of profit motive. Continuous losses sustained beyond the period which is necessary to bring the operation to profitable status that are not due to customary business risks or reverses indicate that the activity is not operated as a trade or business being engaged in for profit. When income is attributable to an activity lacking a profit motive, a loss from the activity cannot be claimed on Form 990-T.

The most common reason, by far, for disallowance of losses and NOLs in the college and university exams was that claimed losses were connected with an activity for which the school lacked a profit motive, as evidenced by years of sustained losses. The IRS disallowed losses and NOLs for lack of profit motive at 70 percent of colleges and universities examined. These disallowances amounted to more than \$150 million of the total losses and NOLs disallowed in the college and university exams.

Note from the statistics above that a total of about \$170 million in losses and NOLs were disallowed. This means that more than 88% of the disallowances were due to “an activity lacking profit motive.”

The IRS also found problems with “misallocations of expenses,” math errors, and unrelated activities wrongly classified on Form 990-T as related to the institutions’ exempt purpose. Again, these appear to have accounted for less than 12% of the dollar amount of the changes.

The issue of misallocated expenses is an interesting concept. There are several situations where the IRS lost in court regarding expense allocations but still refuses to follow the court mandates. The information in the Final Report does not give us clear enough, specific data to ascertain what the “misallocations” were, but this remains a gray area in the law.

The Final Report gives this background with regard to “misallocations:”

When a trade or business activity serves both exempt and unrelated purposes, the income and expenses from the activity must be allocated between the two on a reasonable basis. Allocated expenses must have a proximate and primary relationship to the activities to which they are attributed. Only the expenses allocated to an unrelated trade or business are allowable as a deduction against UBI. Expenses attributable to accomplishing an organization’s exempt purpose may not be deducted because the organization is already exempt from paying tax on related income.

Expense deductions were disallowed on more than 60 percent of Form 990-Ts examined because they were based on improper allocations between exempt and unrelated business activities.

It is important to be very diligent and careful to utilize well-designed formulas and conduct adequate research when allocating expenses between activities that are related to your exempt purpose and those that are unrelated.

The IRS also commented on “misclassification” of activities by colleges and universities in the audit group. This is what they had to say:

The IRS looked at activities that were not reported on Form 990-T to determine whether they were properly omitted. Activities that are substantially related to an organization’s exempt purpose are not reported on Form 990-T. Likewise, certain income is specifically excluded from Form 990-T reporting. When activities are not reported on Form 990-T, they are effectively treated as if they are related activities. Income from related activities is not subject to tax.

At more than 40 percent of colleges and universities examined, activities that were effectively treated as related were determined, upon examination, to be unrelated activities that should have been reported on Form 990-T, and were subject to tax. These adjustments totaled nearly \$4 million. Less than 20 percent of these activities generated a loss.

Finally, from the UBIT perspective, the IRS wanted to see which of the 34 audited colleges and universities sought outside advice with regard to UBIT issues. Here is what they discovered:

The IRS found that about 20 percent of colleges and universities examined sought outside advice about the tax treatment of specific potentially unrelated business activities. In about 40 percent of those cases where an institution had obtained an outside opinion, the IRS did not agree with the opinion when the issue came up on examination. For example, based on outside advice, the college or university might have treated an activity as related to its exempt purpose, but the examination resulted in reclassifying that activity as unrelated.



Rodgers Chapel, Mount Olive College, Mount Olive, NC

Now, 20% of the 34 institutions examined would be about seven universities, and 40% of those would be two or three. So the IRS (which may or may not have been correct in their presumptions) disagreed with two or three outside advisors out of 34 audits. It would have been helpful if the IRS had enumerated what the facts and “disagreements” were in those few instances. Further, this appears to indicate that the IRS agreed with the outside advisors about 93% of the time.

The Final Report provided the following statistics with regard to outside advice and Form 990-T:

- 13% were reviewed by outside counsel before they were filed with the IRS
- 57% were reviewed by independent accountants before they were filed with the IRS
- Half of Form 990-Ts were reviewed by the board of directors or a board committee before filing

Based on this information and what the IRS concluded about UBIT issues in the Executive Summary of the Final Report, you should take a long look at your UBIT processes and ensure that you adjust NOLs, revisit allocation methodologies, diligently research related versus unrelated activities, and seek outside advice when and where indicated. We will continue to push for specific examples from the IRS of what they found and disagreed with regarding UBIT issues.

CUCP: COMPENSATION

The IRS has been focusing more intently on executive compensation at tax-exempt organizations in recent years. It was one of the primary areas reviewed during the CUCP audits, and given its own section in the Final Report.

The “Compensation” section of the CUCP Final Report begins with this qualifier:

The executive compensation component of the examinations focused on compliance with Section 4958 of the Code, which applies to organizations exempt from tax under section 501(a) and described under sections 501(c)(3) or 501(c)(4). This includes the private colleges and universities selected for exam. Section 4958 generally does not apply to public colleges and universities, and they are not included in the Examinations section on Reasonableness of Compensation.

Section 4958 of the Internal Revenue Code deals with “excess benefit transactions” with regard to “disqualified persons.” The 2012 Form 990 glossary defines these two terms as follows:

Excess benefit transaction – In the case of an applicable tax-exempt organization, any transaction in which an excess benefit is provided by the organization, directly or indirectly to, or for the use of, any disqualified person, as defined in section 4958. Excess benefit generally means the excess of the economic benefit received from the applicable organization over the consideration given (including services) by a disqualified person, but see the special rules below regarding donor advised funds and supporting organizations.

Disqualified person – For purposes of section 4958; Form 990, Parts IX and X; and Schedule L (Form 990 or 990-EZ), Transactions With Interested Persons, Parts I and II, any person

(including an individual, corporation, or other entity) who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during a 5-year period ending on the date of the transaction. If the 5-year period ended within the organization’s tax year, the organization may treat the person as a disqualified person for the entire tax year. Persons who hold certain powers, responsibilities, or interests are among those who are in a position to exercise substantial influence over the affairs of the organization.

A disqualified person includes:

- A disqualified person’s family member,
- A 35% controlled entity of a (1) disqualified person and/or (2) family members of the disqualified person,
- A donor or donor advisor to a donor advised fund, or
- An investment advisor of a sponsoring organization.

The instructions to Form 990, Appendix G (“Section 4958 Excess Benefit Transactions”) also provide much insight into this issue. This appendix states, in part:

Reasonable compensation is the valuation standard that is used to determine if there is an excess benefit in the exchange of a disqualified person’s services for compensation. *Reasonable compensation* is the value that would ordinarily be paid for like services by like enterprises under like circumstances. This is the section 162 standard that will apply in determining the reasonableness of compensation.

The code and regulations behind Section 4958 impose a two-tier penalty system on excess benefit transactions. Tier 1 penalties are imposed at 25% of the amount of the excess benefit and Tier 2 penalties are imposed at 200% of that same amount. In addition, the disqualified person must reimburse the organization for the amount of the excess benefit. As you can see, these penalties and payments have the potential to become substantial.

The key to avoiding excess benefit transaction penalties on “unreasonable compensation” is found in the rebuttable presumption provisions of Treasury Regulation 53.4958-6. This section stipulates that the burden of proving that compensation is “unreasonable” falls upon the IRS if the organization follows that section’s three-part process:

1. An independent body reviews and establishes the amount of compensation in advance of actual payment;
2. Permissible comparability data is used to establish the compensation; and
3. There is contemporaneous documentation of the process used to establish the compensation amount.

If these requirements are not met, the organization has the burden of proving reasonableness.

In the Final Report, the IRS looked very closely and deeply at the compensation data used at the approximately 17 private colleges and universities that were audited. In fact, the Final Report states that the IRS also “enlisted the aid of LB&I Engineers to look behind the process and evaluate the comparability data relied upon in establishing the rebuttable presumption.”

The summary of findings states:

About 20 percent of the private colleges and universities included institutions in their data set that were not similarly situated. Engineers looked to factors such as: type (e.g., private or public; liberal arts, research university, etc.), size of undergraduate enrollment, faculty size, location (urban, rural, suburban; region of the US), endowment size, tuition and cost to attend, selectivity (SAT ranges, etc.) and age of the institution (year founded). *The engineers found institutions were not comparable based on at least one of the following factors: location, endowment size, revenues, total net assets, number of students, and selectivity.* (Emphasis ours.)

While this information provides us with good insight into what the IRS is thinking in this area, note that 20% of the approximately 17 private colleges examined means that only three or four schools did not use “qualified” comparability data.

Interestingly, in referring to “failure to include in income the value of the personal use of automobiles, housing, social club memberships and travel” in Footnote 21, the IRS appears to wave the white flag on their much-publicized “automatic excess benefits.” That footnote states:

Inclusion of these amounts in the income of the disqualified persons who received these benefits did not result in excess benefit transactions. The benefits were not automatic excess benefit transactions under section 4958(c)(1)(A) because they were described in employment agreements, and the amounts involved did not render the disqualified persons’ total compensation amounts unreasonable.

So what does that say about the rigorous reporting requirements of Schedule J (Form 990), Part I, Line 1a?

The “Compensation” section of the CUCP Final Report also contains much data on compensation paid to officers, directors, trustees, key employees, and highly compensated employees. While somewhat interesting, at the end of the day the data here is highly skewed by large (and predominantly public) universities with medical schools and nationally recognized NCAA Division I sports programs. Suffice it to say, high-profile sports coaches, investment managers, and (at about 30% of the schools) medical school personnel tend to be highly compensated.

With that in mind, the Final Report states:

The IRS opened employment tax exams at 11 of the colleges and universities examined. All of the completed exams resulted in adjustments, amounting to increases in taxable wages of \$35,540,808.98 and generating \$7,076,387.22 in employment taxes (federal withholding, Social Security and Medicare) and \$167,242.90 in penalties.

Again, consider the data at large, public institutions as you filter these amounts.

As we noted earlier, about 12% of the 183 Form 990 filers in this year’s *Tax Reporting Trends* survey indicated that they did not use the “rebuttable procedures” for their CEO/president. Beyond that, more than 30% said that they did not utilize these procedures for other officers, directors/trustees, and key employees. We highly advise you to institute these procedures (found in Treasury Regulation 53.4958-6) if you are not already using them. You should also carefully consider whether your “comparability data” is truly comparable.

CUCP: ADDITIONAL DATA ANALYSIS

Finally, we wanted to review some of the data contained in the Final Report, including Appendix C, and note how it compares to data from our recent *Tax Reporting Trends* surveys.

Appendix C is titled “Additional Data Analysis” and is designed to “supplement the presentation of questionnaire data provided in the Interim Report.” As we mentioned previously, the IRS released the CUCP Interim Report in May 2010. It contains a large amount of data on the 94 questions — many of which have multiple parts — asked in the 33-page 2008 CUCP questionnaire. The Interim Report, which is available at http://www.irs.gov/pub/irs-tege/cucp_interimrpt_052010.pdf, notes:

... questionnaires were mailed to a representative sample of 400 organizations thought to be exempt from federal income tax under Code section 501(c)(3) or whose income is excluded from federal income tax under Code section 115. The colleges and universities were stratified into three sizes for purposes of determining the representative sample. Per the National Center for Education Statistics, small colleges and universities are defined as those with fewer than 5,000 students. Medium-sized colleges and universities are those with 5,000 to 14,999 students. Large colleges and universities are those with 15,000 students or more.

There are a few things to keep in mind as we review the key data from the Final Report:

- Of the 200 “small” colleges that were mailed the CUCP questionnaire, 159 were ultimately included in the CUCP
- 139 of these small institutions were labeled “private” colleges
- Of the 342 total schools included in the CUCP, 177 (almost 52%) were private colleges. (As a side note, the Interim Report included 344 schools and the Final Report data refers to 342, so we somehow lost two along the way.)
- 78.5% of private colleges were small institutions

So, sit back, make sure your seat belts are fastened and your tray tables in the upright and locked position, and let us be your tour guide through key data in the Final Report, plus some of the more interesting data summaries and editorial information presented in the “hidden” Appendix C.

Enrollment, Tuition, and Programs

First, the Final Report presents data from the questionnaire in Public, Private, and Total columns. As we noted above, almost 80% of the private institutions are classified as small institutions, with fewer than 5,000 full-time equivalent (FTE) students. Since 94.6% of the respondents in the *2013 Tax Reporting Trends* survey are in this “small” category, we will focus on the private results reported in Appendix C of the Final Report. (As a heads up, note that the bar graph colors change about halfway through the Final Report. Up through page 32, blue is used to denote private institutions and red is used for public institutions. At page 33, the colors switch.)

Question 2 in the initial questionnaire asked about FTE students. The average for private schools in the CUCP was 1,800. Among our survey respondents, the average was 1,712.

Question 11 asked about tuition rates. For private schools the averages were:

Question 11a, in-state tuition:	\$15,700
Question 11b, out-of-state tuition:	\$15,900

Among private schools, the average tuition discount for both in-state and out-of-state tuition was 24% (Question 12).

In terms of distance learning (Question 14), 53% of private schools conducted distance learning activities and 32% conducted educational programs outside the U.S. (Question 15).

Endowment Funds, Compensation, and Governance

Section III of the questionnaire concerns endowment funds. Question 32 asks, "Did your organization have endowment fund(s)?" In the data, 86% of private colleges answered "Yes." Correspondingly, 85.8% of Form 990 filers in our 2013 survey show that they hold endowment funds and complete Schedule D, Part V accordingly.

In the "Compensation" section in Appendix C of the CUCP Final Report, the IRS states that:

Question 17 asked respondents to indicate the job titles (Faculty, Heads of Department, Sports Coach, Administrative/Managerial, Investment Manager, or Other) that describes the position(s) held by each of the five highest paid employees. Several respondents listed a person that held one or more title. The following graph and table show the average and median compensation paid by the respondent organization plus compensation from related organizations to the highest paid employees.

You should be very careful when reviewing the data in the report. For instance, on the bar graph for Question 17 (Figure 62) the average salary for "Sports coaches" at small colleges was \$216,678 and the median salary was \$95,162 — quite a spread. Then you see that the population for this data was only seven!

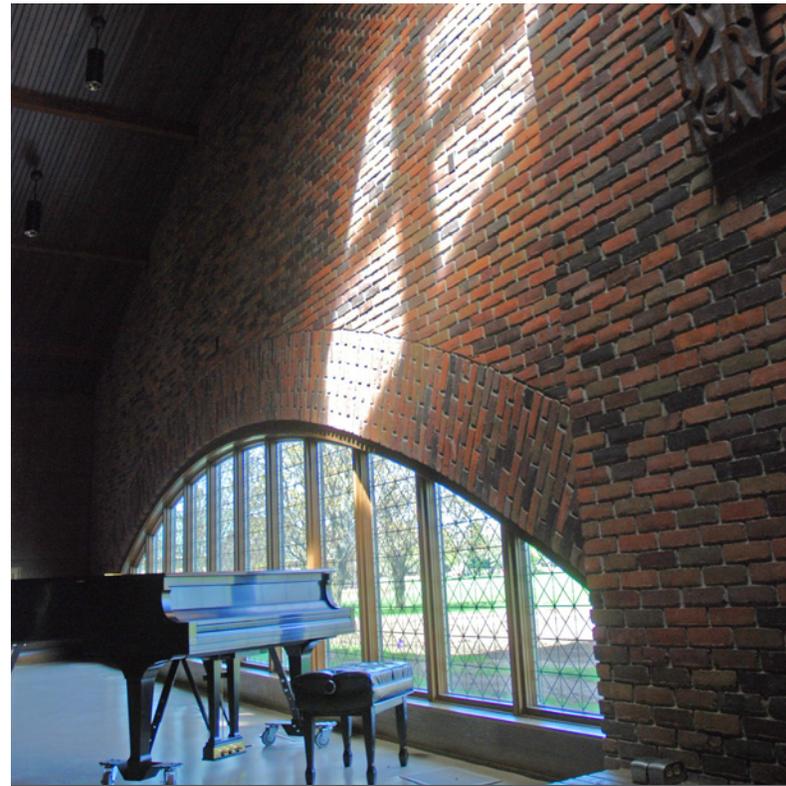
Under the "Governance" section of the data analysis, the report states:

Governance is the exercise of authority and control in an organization. The IRS has viewed governance as an important topic for many years, and in June 2007, introduced the redesigned draft Form 990, which included a section on governance. Effective for tax years beginning with 2008 tax year, exempt organizations were required to file a Form 990 that included a section on governance topics. As a measure of the IRS's continued interest in this area, every section of the Questionnaire included questions related to the governance of colleges and universities. The governance questions addressed policies on conflicts of interest, compensation, endowments, unrelated business activities, and transactions with related parties.

Question 8 asked about private organizations with a written conflict of interest policy governing their ruling body and top management officials, with 81% of private institutions answering "Yes." Similarly, 73.3% of respondents in our 2013 survey stated that they had updated their conflict of interest policy in the past four years.

There is a great deal more data in Appendix C related to compensation issues, unrelated business activities, tuition, financial data, endowment management, investments, and governance. We recommend that everyone in higher education leadership review the Final Report, Additional Data Analysis (Appendix C) and the Interim Report. Take the time to study the data and compare it to the outcomes shown by your college, university, or seminary.

And as always, please do not hesitate to contact us if you have any questions or if we can assist you in any way.



Anabaptist Mennonite Biblical Seminary, Elkhart, IN

Coming next year...

We are considering a music theme for the *2014 Higher Education Tax Reporting Trends Project*. There are many aspects of music schools, programs, and events that institutions of higher education need to consider. Does your institution receive royalties for musical compositions, for example? Do you have a college radio station (with your own tower)? Do you conduct music camps? Hold music concerts on campus? Have or sponsor a traveling music group or band?

As we begin planning the *2014 Tax Reporting Trends Project*, we'd love to have your input on questions and what to look for on Form 990. Please keep in mind that questions should be Yes/No in nature and should not require the respondents to dig deep to look up answers. Please send suggestions to Dave Moja at dmoja@capincrouse.com. Thank you!

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